

# DON'T GET THE BOOT: 1031 EXCHANGES FOR OIL, GAS, AND MINERAL INTERESTS

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## I. Introduction

Contrary to popular thought, 1031 Exchanges do not benefit only commercial real estate investors, and they may be a tax-saving option for mineral investors. Operators, non-operators, and investors in minerals and other oil and gas interests (collectively, “Oil and Gas Interests”) have the opportunity to participate in these like-kind exchanges as well.

In a typical real estate transaction, the seller pays gains taxes on its amount realized. A seller that is concurrently selling and buying real property may avoid paying these taxes by filing an exception under 26 U.S.C. § 1031 (“1031 Exchange”). This exception allows the seller to avoid recognizing any gain on the sold property “if such real property is exchanged solely for real property of *like kind* which is to be held either for productive use in a trade or business or for investment.”<sup>1</sup> Case law explains that the rationale behind a 1031 Exchange “is the concept that a taxpayer’s economic situation following the exchange is essentially the same as it had been before the transaction.”<sup>2</sup>

The statutes set forth the basic requirements for a 1031 Exchange, but determining whether the properties meet those standards can be tricky. A transaction involving Oil and Gas Interests creates even more uncertainty. Below, this article sets out the statutory requirements for a 1031 Exchange and explores several of the common issues to consider if you file a 1031 Exchange for Oil and Gas Interests.

## II. Requirements for a 1031 Exchange

In order to qualify as a 1031 Exchange, a transaction must meet the following standards:

- a) Both sides of the transaction must deal with real property;
- b) The sale and purchase must involve investment property and cannot be for personal use;
- c) The property must be located in the United States;
- d) The property purchased (“Replacement Property”) must be of equal or greater value. If the Replacement Property is less, the difference is taxable (referred to as the “Boot”);
- e) The properties must be of like kind;
- f) You must identify a Replacement Property within 45 days of sale; and
- g) You have 180 days after the sale of your property to complete the exchange.

Oil, gas, and mineral investors run into unique issues with several of the standards above. Whether or not the properties are “real property” and of “like kind” seems to create the greatest confusion. The courts have addressed several of these nuanced complexities. Here we explore in greater depth their responses to requirements (a) and (e) insofar as they pertain to a 1031 Exchange of Oil and Gas Interests.

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<sup>1</sup> 26 U.S.C. § 1031(a)(1) (emphasis added).

<sup>2</sup> Peabody Nat. Res. Co. v. Commissioner, 126 T.C. 261, 276 (2006).

### III. Real Property vs. Personal Property

In order for a transaction to be exempt from gains taxes, the interests exchanged must be real property and located in the United States. Whether or not property is considered real or personal property is dependent on the laws of the state where the interest is located. For the sake of brevity, this article focuses on minerals, oil and gas leases, and overriding royalties.

Severed minerals in place are considered real property and subject to separate taxation in Colorado, satisfying the first requirement for a 1031 Exchange.<sup>3</sup> Alternatively, extracted minerals are considered personal property in Colorado and subject to a severance tax.<sup>4</sup> If your transaction involves solely minerals in place, then you satisfy the requirement of real property. In addition, oil and gas leases and in some cases, overriding royalty interests, are considered real property in Colorado.<sup>5</sup> Kansas, Utah, and other states have also taken the position that oil and gas leases are considered real property.<sup>6</sup> An overriding royalty interest in Colorado is considered real property “for those purposes which affect the land involved and as a personal property interest for purposes of payments that arise from such interest.”<sup>7</sup> In other words, if the override is tied to the land itself, it is real property. If it amounts to actual payment under a lease, it is considered personal property. Whether an oil and gas lease or an overriding royalty interest is considered real property varies state to state. If your transaction involves either of these, consult with an oil and gas attorney.

### IV. Nature, Character, or Class

Just because the exchanged properties are real property does not mean that the transaction qualifies for § 1031 protection. The properties must also be of “like kind,” a standard that causes confusion for even the most experienced investors. To determine whether Oil and Gas Interests are of like kind, the courts consider the nature, character, or class of the properties. Courts have held that like-kind property does not mean that the Replacement Property must be of the same substance, quality, or grade. For example, in *Commissioner v. Crichton*, the court held that the transfer of interest in an improved lot for a perpetual undivided overriding royalty interest tied to a vacant lot, although being a different type of real property, could still qualify for § 1031 protection.<sup>8</sup> The distinction between the type of real property “in location, in attributes and in capacities for profitable use” does not matter. Instead, the distinction should be “between classes and characters of property, for instance, between real and personal property.”<sup>9</sup>

To determine whether properties are of like kind, the courts consider the nature, character, or class of each transaction. Although the *Crichton* court held that the exchange of an improved lot for an overriding royalty interest is a like-kind exchange, the court in *Fleming v. Commissioner* held otherwise under the nature, character, or class doctrine.<sup>10</sup> In *Fleming*, the petitioners sought to avoid paying gains taxes by exchanging overriding royalty payments on

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<sup>3</sup> See *Smith v. El Paso Gold Mines, Inc.*, 720 P.2d 608, 609 (Colo. App. 1985).

<sup>4</sup> See 2 R. Tiffany, *Law of Real Property* § 587 (3d ed. 1939); see also *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir. 1957).

<sup>5</sup> See *Kinder Morgan CO2 Co. v. Montezuma Cnty. Bd. of Comm’rs*, 396 P.3d 657 (Colo. 2017).

<sup>6</sup> See *In re Kittle*, 32 B.R. 690 (1983).

<sup>7</sup> See *Grynberg v. Waltman*, 946 P.2d 473 (Colo. App. 1996).

<sup>8</sup> 122 F.2d 181, 182 (5th Cir. 1941).

<sup>9</sup> *Id.*

<sup>10</sup> 24 T.C. 818 (1955).

producing oil and gas leases for fee simple title to 2,994½ acres. The overriding royalty payments were for a specified duration and terminated thereafter. The court held that the exchange did not qualify as a like-kind exchange, distinguishing the facts from *Crichton*. It considered whether the Replacement Property was of the same nature and character. To determine character, the court focused on “[t]he rights created in the property.”<sup>11</sup> It noted that “[i]f there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind.”<sup>12</sup> Because the petitioners in *Fleming* received an overriding royalty for a limited time, they received “a temporary title to the oil properties,” which are “not equivalent to an absolute and unconditional title in the ranch land. The rights created were wholly different.”<sup>13</sup> In other words, the duration of the interest is a factor in determining if properties are of like kind. The overriding royalty in *Crichton* was tied to the land and would continue until the minerals had been exhausted, whereas the overriding royalty in *Fleming* terminated after a specified quantity of minerals were produced or sold. Because the overriding royalty in *Crichton* was for an indefinite period of time, the court considered it a like-kind interest having the same character as the improved land that was exchanged. The *Fleming* court held, however, that because the overriding royalty interest was limited for a period of time, it was of distinct character from the fee simple interest exchanged.

In 2006, the Tax Court once again focused on the nature, character, or class standard regarding a 1031 Exchange of mineral interests in New Mexico. In *Peabody Natural Resources Co. v. Commissioner*, the court held that a gold mine is of like kind to a coalmine that is subject to supply contracts, each contract having a termination date and an option to extend. The court held that the supply contracts were considered real property under New Mexico law, but as stated above, an exchange of real property does not in itself qualify as exempt under § 1031. Instead, “consideration is to be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.”<sup>14</sup> The petitioner in *Peabody* argued that the supply contracts, like the overriding royalty interests in *Crichton*, existed in perpetuity and should be considered like-kind property. The court rejected this argument, noting that here the supply contracts would terminate without renewals. Even though the supply contracts were subject to expiration, similar to *Fleming*, the court held that the exchange of the gold mine for a coalmine subject to supply contracts is a like-kind exchange. The court did not focus on the duration of the contracts. Instead, it held that the “right to mine and extract coal from the ... land and its supply contracts payment rights for the coal cannot be separated from its ownership of the [coal mine]. Those rights are a part of the bundle of rights incident to Peabody’s ownership of the coal reserves.”<sup>15</sup> Further, “the right to receive income from the tenant is part of the bundle of rights ancillary to and inherent in the ownership of the realty.”<sup>16</sup> Instead of focusing on the duration of the supply contracts, the *Peabody* court held that they were of like kind because they were intrinsically part of the mine and the ownership of the land itself.

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<sup>11</sup> *Id.* at 824.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 826.

<sup>14</sup> 126 T.C. 261, 273 (2006)

<sup>15</sup> *Id.* at 278.

<sup>16</sup> *Id.*

Finally, the Tax Court has held that the exchange of a royalty on minerals transferred does not necessarily constitute a like-kind exchange under the nature, character, or class doctrine. In *Crooks v. Commissioner*,<sup>17</sup> the petitioners conveyed minerals to Henry Energy Corporation in exchange for four farms, farm equipment, and a one-fourth royalty interest in and to the minerals they conveyed. The court applied an economic interest test and examined whether the petitioner retained an economic interest in the property transferred. Because the petitioners retained an economic interest in the minerals they transferred, the court interpreted the royalty received as a lease bonus on a lease, rather than a sale of property. It concluded that the nature of the transaction constituted a lease, rather than a sale, meaning that not only must the property exchanged be of like kind, but the nature of the transaction itself must be of like kind.

## **V. Takeaways**

Given the nuanced distinctions made above, it is understandable why there is so much confusion around 1031 Exchanges and Oil and Gas Interests. When filing a 1031 Exchange for the transfer of Oil and Gas Interests, the transferor should pay particular attention to whether the interests exchanged are classified as real property in the state in which they are located, and whether the nature, character, or class of the properties and the transactions themselves are considered like kind. This second requirement is less defined and should be considered on a case-by-case basis. Prior to filing a 1031 Exchange of Oil and Gas Interests, you should consult with a legal expert that is familiar with the complexities involved when filing a § 1031 exemption for Oil and Gas Interests.

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<sup>17</sup> 92 T.C. 49 (1939).